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Tax Aspects of Intellectual Property

*Lawrence R. Bloomenthal**

CREATIVE ACTIVITY in the scientific, technical, literary, musical and artistic fields is encouraged by preferential treatment under the income tax laws. While musicians, authors, composers and inventors all receive some special tax benefits, inventors are awarded the most valuable tax breaks.

Amateur Authors

Since 1950 the income tax laws have discriminated against amateur or "non-professional" creative work in the fields of music, art and literature. This was due, in part, to the publication by General Dwight D. Eisenhower of his war memoirs, *Crusade in Europe*. Asserting that the manuscript was the work of an amateur author, his publishers obtained a revenue ruling upholding taxation of the entire proceeds of approximately $1,000,000 as capital gain.[1]

After considerable critical publicity, Congress amended the Revenue Code of 1939 so as to exclude copyrights as well as literary music and artistic works from the definition of capital assets. Consequently, amateurs now receive the same tax treatment as professionals: neither of them can obtain capital gains on the sale of their work. The Internal Revenue Code of 1954 adopted these rules without change so that, to this day, there is continuing discrimination in these fields.[2]

Capital Gains for Inventors

In direct contrast, Sec. 1235 of the 1954 Code automatically grants long-term capital gains status to the proceeds realized by an inventor upon transfer of all substantial rights to a patent. No distinction is made between amateurs or professionals and it is unnecessary for the property to be held for six months before the date of sale, as is usually necessary to qualify for long-term capital gains. Also, payments can be made contingent on the productivity, use or disposition of the property transferred. It is permissible to provide for payments over a period ending with the transferee's use of the patent.

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1 A review of the events leading to the 1950 amendment appears in the September, 1958 issue of Journal of Taxation, pp. 140, 142. See also, Taylor, Tax Relief for Income Attributable to Several Years, 36 Taxes, 701 (1958).

2 Sec. 1221 (3), I. R. C. 1954 excludes copyrights, etc. from definition of capital asset; Sec. 1231 (c) excludes copyrights, etc. from depreciable property capital assets.

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Substantial Rights

The nature or extent of the rights which must be transferred is not expressly defined in Sec. 1235. Litigation on this point usually involves the question of whether the inventor has retained more control over the manufacture, use and sale of the patented device or product than is necessary for his own protection.

In the case of *Arthur M. Young,*[3] the Tax Court ruled that there was no transfer of all substantial rights to the patents on certain helicopter improvements, because the inventor had retained the right to terminate the transfer at any time and for any reason. The Tax Court refused to accept the taxpayer's argument that termination was highly unlikely because Young then would not recoup anything of substantial value.

Agreeing with the Commissioner, the Tax Court pointed out that there was a distinct advantage to Young if he should terminate, because he would then have the sole right to sue in his own name for patent infringement and this right could be of great economic value. He could then make other assignments which might produce greater royalties than he was receiving under the original agreement with Bell Aviation Corporation. The Second Circuit Court of Appeals has affirmed this decision.[4]

Cancellation Privileges

Does retention of the right to cancel a patent assignment for failure to produce or market a specified quantity of the patented items disqualify the inventor from the benefits of capital gains? In *Golconda Corp. v. Commissioner,*[5] the reservation of cancellation rights was held to be immaterial so long as the assignment prohibited the inventor from making, using or selling the patented item anywhere within fixed territorial limits. This case also established that it is permissible for the inventor to retain termination power if production falls below a specified quantity. Here, the restriction was that the assignment of patents to diamond saw teeth could be cancelled if production was less than 80% of the transferee's entire business in diamond variety saw teeth.

Unlimited sublicenses or assignments by the transferee may be restricted by the inventor without jeopardizing his taxable status for capital gains purposes.[6]

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[3] 29 T. C. 850 (1958), affd., (2d Cir. 1959) 59-2 U. S. T. C. Par. 9589.

[4] Supra note 3.

[5] 29 T. C. 506, (Acq.) (1957); Orla E. Watson v. U. S. 222 F. 2d 689 (10th Cir. 1955). (Failure to make 2600 collapsible grocery carts in six months period).

[6] Carroll Pressure Roller Corp. 28 T. C. 1288 (1957), app. dism. by stip.; Rev. Ruling 58-353. I. R. B. 1958 29, 15.

Geographical Limitations

Restrictions can be imposed by the inventor on the manufacture, sale and use of patented items outside of a specified geographical area and still permit him to claim the tax advantages under Sec. 1235. An exclusive assignment also can limit use of the transferred patents to a single industry, such as tuna canning, especially when that is the only industry in which the particular rights have any real value.[7]

Splitting Single Patents

An unusual situation arose in a case in which the Merck Drug Company was claiming an income tax refund of more than $300,000.00 on the theory that it had erroneously reported income from transfer of certain patent rights as ordinary income rather than as capital gains. *Merck and Company* owned a single patent which covered a number of separate inventions on the chemical compounds commonly known as the sulfa drug.

By an exclusive license agreement, the complete rights to sulfadiazine were transferred to another company. The government argued that an assignment of less than all of the rights covered by a single patent, or an undivided interest in all such rights, did not constitute a sale. Consequently, the assignment must be treated as a license resulting in ordinary income.

The District Court, however, disagreed, and decided in favor of the plaintiff.[8] In its opinion, the Court stated that all of the rights pertaining to a particular portion of a single patent had been transferred and that this was sufficient to qualify the proceeds as long-term capital gains. While this decision involved years before Sec. 1235 became effective, the same results would follow under the present statute.

Product Limitations

In the case of *First National Bank of Princeton v. United States,*[9] the use of assigned patent rights was limited to the manufacture and sale of toothbrushes even though the patented device was broad enough to cover almost every other kind of brush. It was held that product limitations did not interfere with a complete transfer of all substantial rights.

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7 Eben H. Carruthers, 219 F. 2d 21 (1st Cir. 1955); R. H. Crook 135 F. Supp. 242 (1955).

8 Merck & Co., Inc. 155 F. Supp. 843, (1957) affd. 261 F. 2d 162, (3d Cir. 1959) cert. not authorized. Revenue Ruling 59-175, I. R. B. 1959—20, 13 holds that a transfer of an undivided one-half interest or other transfer of a complete fraction of a whole patent complies with Sec. 1235, I. R. C. 1954.

9 136 F. Supp. 818, (1956), app. dism.

Sales Price Veto

In another case, *Arras v. United States,*[10] the inventor of an automobile hose clamp retained the power to set sales price levels, subject to adjustment to meet competition. There were a number of other reserved powers which the Commissioner conceded would not necessarily prevent the transfer from compliance with the requirements of Sec. 1235.

The agreement stated that the purchaser was acquiring exclusive rights for the manufacture, sale and use of the device covered by the patent. However, Arras retained legal title, a veto over sub-licensing, the right to check the books of the transferee, an option to cancel if the patent were shelved, a right to terminate for breach and a duty to defend against infringement.

The District Court of Connecticut stated that no single one of these powers considered individually would necessarily prevent the transaction from qualifying as a complete transfer. Upon consideration of all the facts, it was decided that the combination of reserved rights did not add up to the reservation of too many substantial powers, since Arras had completely surrendered all rights to exploit the patent himself.

Right to Sell

The usual rule in patent law cases is that an assignee of a patent has no right to sue in his own name for infringement unless he has been granted the exclusive privilege to use the patent for a term of 17 years and to make and sell the articles or devices throughout the United States and its territories. The problem under Sec. 1235 is whether there can be a transfer of "all substantial rights" unless the agreement specifically includes exclusive rights to make, use and sell.

The Tax Court has followed the rules of patent law quite literally and has ruled in one case[11] that there is no transfer of all substantial rights unless the inventor has conveyed the exclusive right to "make, use and sell" the invention. Any assignment or transfer lacking one of these elements interferes with a complete transfer, and capital gains would not be available under Sec. 1235.

However, in the *Lawrence* case,[12] decided by the Fifth Circuit Court of Appeals in 1957, it was held that the right to sell need not be included in express language unless this is a substantial or valuable right in itself. The *Lawrence* case involved the transfer of rights to a device for removing pipe and other obstructions from oil wells. Despite the Government's contention that the right to sell was a necessary qualification under Sec. 1235, the Court of Appeals decided that neither party considered

10 164 F. Supp. 150 (D. C. Conn. 1958).

11 Arthur B. Young, supra note 3.

12 Richard R. Lawrence v. U. S., 242 F. 2d 542 (5th Cir. 1957).

the sale of the tools advisable because of their highly specialized nature, requiring skilled operators. Consequently, to prevent injury to the reputation of the tool and to prevent damage to oil wells, the parties agreed that the transferee should lease rather than sell these tools.

Right to Use

In the *Gruber* case,[13] the Government contended that there had not been a complete transfer because the agreement failed to confer an unlimited right to use the patent in addition to the right to manufacture and sell the "View-Master," a device for viewing stereoscopic slides. The District Court in Oregon pointed out that the Government had failed to prove that the right to use had any substantial value by itself. The valuable rights were for manufacture and sale so that the right to "use" the device was automatically granted by the right to manufacture and sell.

Too Many Rights

Occasionally, an inventor will retain too many rights and thereby deprive himself of capital gains. In *James R. Watkins v. United States*[14] Watkins retained six privileges, which the Appellate Court decided gave him so many rights and interests, both present and future, that there was much less than a complete transfer.

An especially objectionable feature of the arrangement was that the grantee received a "non-transferable exclusive license for the use of" the various patents. Watkins explained that his intention was to confer manufacturing and selling rights by allowing the grantee to use the patents, and argued that all the other retained interests were merely incidental and did not affect the transfer of all substantial rights. The Court upheld the Commissioner in taxing the proceeds as ordinary income.

The Court suggested that a complete transfer in good faith could have been accomplished in simple language, in a single agreement, rather than by the execution of five highly technical contracts. It was apparent to the Court that Watkins was attempting to secure maximum tax advantages while, at the same time, retaining as many rights as possible.

Rights of Employees

Does an inventor have any "substantial rights" in an invention or patents which he has perfected while a full time employee? Under the rules of patent law, an employer has "shop rights" consisting of a non-exclusive right to practice or exploit any invention developed by an employee during his hours of

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13 Wm. B. Gruber v. U. S., 158 F. Supp. 5 (D. C. Ore. 1958) taxpayer appeal pending to C. A. 9 on another issue. See also; E. E. Rollman, 244 F. 2d 634 (4th Cir. 1957); National Bread Wrapping Machine, 30 T. C. 550 (1958).

14 252 F. 2d 722 (2d Cir. 1958); cert. den., 78 S. Ct. 1384.

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employment while working with the employer's tools and materials. In the case of *Hans Jordan*[15] the Commissioner contended that the entire proceeds realized by Jordan, an electrical engineer, from the transfer to his employer of his full right, title and interest in a patent on a waste disposal unit was compensation for services taxable at ordinary rates. Judge Rice, speaking for the Tax Court, sustained the petitioner, holding that Jordan possessed substantial rights even though the employer had shop rights. There was no dispute about the fact that Jordan's employer had supplied material and working facilities, or that the work was done on the employer's time and with the assistance of fellow employees. Nevertheless, since patent law rules permit the employee to license to other manufacturers or even sell his entire interest, subject to the employer's "shop rights," Jordan still had many valuable rights. Therefore, he was entitled to report the proceeds from their disposition as capital gains.

Sometimes an employer and employee may agree upon a plan for the joint development of patentable inventions. This is not covered by Sec. 1235 because there is no transfer of "rights to an invention" to the employer. In the *Kleinschmidt* case,[16] a mechanical engineer who was an authority in the field of thermodynamics was told by his employer that the Marine Corps was seeking a device for distilling sea water that would be economical and easy to handle. Kleinschmidt divided his time between teaching and acting as an engineering consultant. He was certain he could solve the problem but felt that he could not afford to devote the time required to exploit the device without financial backing. After preliminary work was completed and while a patent application was pending, the invention was transferred to the employer. Their agreement gave Kleinschmidt one-third of all royalties; he agreed to spend whatever time was required to perfect the invention while the employer assumed costs of presenting patent applications and sales expenses. It was decided by the District Court that the arrangement was a joint venture with the employer rather than a sale or transfer of patent rights. Accordingly, all royalties received were taxable as ordinary income and not as capital gains.

Limitation of Benefits

To prevent abuse of the special tax benefits granted by Sec. 1235, the statute limits automatic capital gains to individual inventors and other designated persons. Sec. 1235(b) specifies that a "holder" by whom a transfer will qualify includes only an individual whose efforts created the invention or any other

15 27 T. C. 265, Acq. 1957-1CB4.

16 146 F. Supp. 253 (D. C. Mass. 1956); taxpayer's appeal pending in C. A. 1 (both parties were found to have assumed sharing of risks as well as profits so as to have character of a joint venture).

individual who acquired his interest for valuable consideration prior to actual reduction to practice of such invention. However, an employer or persons "related" to the inventor, within the meaning of the statute, cannot automatically receive capital gain under Sec. 1235 upon transfer of an invention acquired from the inventor. Related "persons" include a spouse, ancestors and lineal descendants of the inventor, as well as any corporation in which the inventor directly or indirectly owns more than 25% in value of the outstanding stock. Sec. 1239 of the 1954 Code positively prohibits allowance of capital gain in any sale or exchange, directly or indirectly, of depreciable property between a husband and wife or between an individual and a corporation in which he, his spouse, his minor children and minor grandchildren own more than 80% in value of the outstanding stock.

Taking Secs. 1235 and 1239 together, it appears that Congress intended to make it extremely difficult for any transfer of patents to a family corporation to qualify for capital gains under present law. Nevertheless, there is the possibility that a transfer to a "related" corporation which does not qualify under Sec. 1235 may still produce capital gains if the inventor, his spouse, his minor children and minor grandchildren *own less than 80%* in value of the outstanding stock. Sec. 1239 does not apply either if the inventor and his spouse own 79% and his *adult children* own 21% in value of the outstanding stock. Other possible combinations of family holdings which would steer clear of Sec. 1239 and still produce capital gains could be suggested. But, the purpose here is to point out a gap in the statutory scheme which probably will require further legislation.

Non-Exclusive Statute

Sec. 1235 provides automatic capital gains treatment for qualified transfers of patent rights. However, this does not prevent capital gains from being recognized on transactions which do not come within the statutory rules. Both the Commissioner and the Courts have declared that Sec. 1235 is not exclusive and was not intended by Congress to cover the entire field of capital gains arising from the transfer of patent rights.[17]

The Commissioner has announced, in Revenue Ruling 58-353, that capital gains may result from a transaction which does not qualify for automatic capital gains because the transferee was a "related person" within the meaning of Sec. 1235 or because the transferor was not a qualified "holder," such as a cor-

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[17] Regulations Sec. 1.1235-1 (b), Sec. 1239, I. R. C., 1954; Rev. Ruling 58-353 I. R. B. 1958—29, 15 (transactions not under Sec. 1235 will be governed by general rules); Coplan 28 T. C. 1189 (1957); Johnson 30 T. C. 675 (1958). Acq. 1958-2 CB 6; Neugass (D. C. Okla., 1959) 59-1 USTC Par. 9310. See also: Rev. Ruling 59-210, I. R. B. 1959-24, 13 which holds that since patents used in a trade or business or held for production of income are depreciable assets, Sec. 1239 forbids capital gain recognition on transfer by inventor to 80% family-owned corp.

poration. All necessary requirements must be met for a complete transfer under the general rules of income tax law. That is, (1) There will have to be a complete sale or disposition of all substantial rights of the transferor; (2) The property will have to meet the statutory tests for qualifying as a capital asset rather than inventory or property held for sale to customers in the regular course of business; and (3) The asset will have to have been held for six months or more before transfer.[18]

The Tax Court has agreed with the Commissioner's interpretation of Sec. 1235. In *Best Lock Corp.*[19] and *Holcomb*[20] the Tax Court stated emphatically that Sec. 1235 provides only one of the methods by which capital gains can be realized in the patent field. Accordingly, where there was a definite sale in every respect and no controversy as to the status of the patents involved as capital assets, a charitable foundation and a donee who did not qualify as "holders" within the meaning of Sec. 1235 were held to be entitled to capital gains treatment on patent transfers.

These decisions do not conflict in any way with the provisions of Sec. 1239, because the transferees were not 80% family owned corporations. All attempts to claim capital gains on transfers by an individual to related individuals, firms or corporations are sure to be scrutinized by the Revenue Service to check compliance with Secs. 1235 and 1239. Transfers by a corporation to another corporation or to individuals may be open to attack if there is any basis for suspecting lack of good faith, even though no particular section of the Code deals expressly with this class of cases.

Settlement of Disputes

Compromise of actual or threatened litigation frequently creates a dispute between the inventor and the Revenue Service as to the taxable character of the settlement proceeds. For instance, in *Rose Marie Reid*[21] the Tax Court held that an agreement settling differences which had arisen between the two stockholders of a corporation formed to manufacture and sell swimming suits resulted in capital gain to Mrs. Reid rather than

[18] F. H. Philbrick, 27 T. C. 346 (1956), Acq. I. R. B. 1958-29, 6; Tobin 18 TCM 431 (2d Cir., 1959); Orla E. Watson v. U. S., 222 F. 2d 689 (10th Cir. 1955) (discusses tests under prior law; same rules applicable now where Sec. 1235 does not apply); E. A. Wolen v. U. S., 59-1 USTC Par. 9341 (D. C. Mass., 1959) pending in C. A. 1 on taxpayer's appeal (parties testified they did not originally intend complete assignment by a non-exclusive, non-transferable, non-revocable right to use a patented process for imparting a protective color finish to the surface of ferrous metals; held not a sale under prior law).

[19] Best Lock Co. 31 TC No. 125, C. C. H. Dec. No. 23, 508 (1959) (non-exempt charitable foundation allowed capital gains).

[20] Holcomb, 30 T. C. 354 (1958) (donee of patents can obtain capital gains even though not a qualified holder under Sec. 1235)—appeals pending in C. A. 6 by Gov't. and taxpayer.

[21] 26 TC 622 (1956) Acq. 1956-2 C. B. 8.

compensation for personal services. The name of "Rose Marie Reid" and certain patents she had obtained on swimming suits for women were extremely valuable. The corporation using these patents was one of the world's largest swim suit manufacturers at the time Mrs. Reid threatened, through her legal counsel, to enjoin it from using her name and to sue for recovery of patents she claimed had been assigned without valid consideration and under fraudulent conditions. To avoid such action, a substantial settlement with Mrs. Reid gave Rose Marie, Inc. complete ownership of the trade name and inventions in dispute. The Government contended that payments under this contract were received for personal services rendered rather than in consideration of the final transfer of valuable property. However, the Tax Court agreed with the taxpayer that she still possessed substantial rights despite an earlier agreement purporting to transfer her entire interest in the patents and trade names. The Court pointed out that Mrs. Reid claimed the agreement was invalid and had threatened to sue for relief; apparently counsel for the company believed she had enough merits in her claims to jusify the settlement. Consequently this was a final property transfer whose proceeds were capital gains.

A different result in the *Ost* case[22] emphasizes the necessity of awareness of tax consequences in drafting agreements pertaining to patent rights. William R. Ost was the inventor of a patented process for joining pipes, and threatened to sue his present and former employers unless they compensated him for his rights. A settlement agreement gave Mr. Ost a specified percentage of the net sales of devices manufactured under his patent, but provided that the amounts so payable were to be reduced by one-half if he ceased to be employed by the company for which he was then working. On these facts and because he continued to work at this employment throughout the entire taxable period, it was found that only one-half of the total payments represented proceeds from the transfer of substantially all of his rights to the invention. To avoid a similar result, employer-employee assignments and settlement agreements should omit any provisions making the compensation to an employee for patent rights contingent in whole or in part upon his continued employment. A separate employment contract would be more advisable.

Intellectual Conceptions

An attempt was made in one recent case to circumvent the statute excluding from capital gains treatment income from the sale of a copyright, a literary, musical or artistic composition in *David Stern, III v. United States.*[23] While in the Army during

[22] 17 TCM 80 (1958); Tygart Valley Glass Co., 16 T. C. 941 (1951) (no showing of sale).

[23] 164 F. Supp. 847 (D. C., D. C., 1958) affd. 262 F. 2d 957; (5th Cir., 1959) cert. den.

World War II, Stern wrote some imaginary dialogue between a Second Lieutenant and an old army mule, suggesting that there was something in the Army lower than a Second Lieutenant. After his discharge, Stern rewrote the episodes about "Francis," the talking mule, in book form and then sold all of his right, title and interest in and to that character to Universal Pictures, Inc. for $50,000.00 plus percentages on net profits from photoplays or other uses of the property. Seven pictures about "Francis" were produced, and Stern contended that his income was taxable as capital gains.

Both the District Court and the Court of Appeals found in favor of Stern for years prior to 1950, but judgment was entered for the Government denying tax refunds for later years. It was held that the statutory exclusions were controlling.

Stern's argument was that the character "Francis" was an intellectual conception which was not subject to copyright and that it was not a literary, musical or artistic composition or similar property. But the District Court ruled that the principal character of the novel, "Francis" was composed of the literary description of his mannerisms and behavior. Without such description, there would be no property capable of ownership and sale. The Court refused to accept the proposition that an idea or mental image by itself could be sold independently from the written material which gives it substance and a form capable of being transferred to others. Parts of a literary composition as well as an entire book, theatrical production, radio program, TV script, newspaper cartoons or any other property eligible for copyright protection are included in the terms of the new statute. Capital gains cannot be realized by their creator from the sale of any such items.[24]

Options

Gains or losses arising from the exercise or failure to exercise options to buy or sell patents are automatically classified by Sec. 1234 of the Code as capital gains and losses if other requirements of the income tax laws are satisfied. This means that in patent option cases capital gains or losses follow if the circumstances bring the deal under Sec. 1235 and do not violate Sec. 1239. Also capital gains and losses result from exercise or lapse of options if the actual sale would have resulted in capital gains or losses under the general rules previously discussed. Obviously, options pertaining to copyrights or copyrightable works qualify for capital gains or loss treatment only if the underlying property is so classified. Secs. 1221 and 1231(1) (c) prevent authors, writers and composers from realizing capital gains on options to sell their creations. Here is another instance of income tax discrimination against work in the literary, musical and artistic categories.

[24] Sec. 1221 (3), and Sec. 1231 (c), I. R. C. 1954.

Damages for Patent Infringement

Compensatory damages for patent infringements can be spread back over the months in which the infringement occurred. Qualifying requirements under Sec. 1304 are somewhat similar to, but much stricter than, those found in other long-term income provisions. Meeting the 80% tests is one of the lesser hurdles. Tax spreading for compensatory patent infringement damages is available only if such damages are received after the commencement of litigation and applies only if the patent was issued by the United States.[25]

Because of the positive language appearing in Sec. 1304, the Treasury Regulations state that an out-of-court settlement before litigation is not covered, and that income spreading calculations cannot be used.[26] Furthermore, it is specifically stated in the Regulations that an out of court settlement even after starting litigation will not qualify unless there is a decree or judgment entered awarding the exact amount paid. Merely dismissing the action at defendant's costs, with prejudice, would not comply with the statute. Settling without litigation obviously would disqualify the payment.

Damages for infringement of copyrights, registered trade-names or trade-marks are not eligible for the same long-term income benefits as compensatory damages for patent infringement. The gist of the differences in their treatment is that tax liability on patent infringement damages can be recomputed on the basis of increases in taxable income which would have resulted if the amount received were included in equal installments for each month during which the infringement occurred. Copyright infringement damages can be spread back only under Sec. 1302 for a period of not more than thirty-six months. No justification for this distinction can be found in any inherent differences in the nature of creative work in the various fields of intellectual endeavor. Perhaps omission of copyright damages from Sec. 1304 was an oversight. Whether deliberate or accidental, it is one of the many inequalities in the tax treatment of intellectual property which should be remedied.

Long Term Income

Income from inventions and artistic works is given special tax limitation benefits if the requirements under Sec. 1302 of the 1954 Code are fulfilled. It is possible also for professional in-

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[25] Special tax spreading provisions cover following types of long-term income: (a) Sec. 1301, I. R. C., from employment; (b) Sec. 1302, I. R. C., from invention or artistic work; (c) Sec. 1303, I. R. C., from back pay; (d) Sec. 1304, I. R. C., compensatory damages for breach of contract or of fiduciary duty of $3,000 or more; (f) Sec. 1306, I. R. C. damages for anti-trust law violations.

[26] Sec. 1304, I. R. C.; Sec. 1.1304-1(b) (1) (IV) Regulations; Par. 4790 B, Vol. 594, C. C. H. Standard Fed. Tax Serv.

(a) Sec. 1.1304-1(b) (1) (i), Regulations, supra;
(b) Sec. 1.1304-1(b) (1) (ii), (iii) and (iv), inclusive, Regulations.

ventors, writers, musicians and artists, to obtain tax limitation on lump sums received in a single year under Sec. 1301 as compensation from an "employment." There is also some tax protection available for this group of creative people from Sec. 1303, dealing with back pay, and Sec. 1305 which covers damages for breach of contract in excess of $3,000.00.

The really important benefits for both amateurs and professionals are to be found in Sec. 1302 dealing with long-term income and 1304 which relates to compensatory damages for patent infringement. The basic purpose of these provisions of the Revenue Code is to minimize the impact of high tax rates which would otherwise result from "bunching" in the taxable income of one year a lump sum which has been earned in or is otherwise allocable to prior years. This is accomplished by limiting the maximum amount of tax payable in the year of receipt to the amount of taxes which would have been paid had the lump sum been received over the years to which it is properly attributable.[27]

Employment Compensation

Compensation from an "employment" qualifies for the "spreadback" treatment if a taxpayer receives in one year at least eighty percent of the total compensation from an employment covering a period of more than thirty-six months. An "employment" is defined in Sec. 1301(b) to mean an arrangement or series of arrangements for the performance of personal services to accomplish a particular result. The Courts agree with the Commissioner that the services involved must relate to a particular project to be completed, rather than to compensation for general services performed for a client or employer.[28] Determination of the correct tax rates to be applied and whether a specific amount received in a particular year qualifies under Sec. 1301 present problems outside the scope of this discussion.[29] It is apparent, however, that wrongful damages for breach of an employment contract or for the wrongful termination of a professional relationship would not qualify as long term income under Sec. 1301. It probably would be eligible for special tax limitation benefits under either Sec. 1303, as back pay, or as damages for breach of contract under Sec. 1305.

Lump sum income from work performed in developing inventions, composing music, writing dialogue, etc. under an employment contract probably would qualify under Sec. 1301 if it relates solely to a definite program or a special situation. Em-

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[27] Sec. 1.0301-1 of Commissioner's Regulations, Par. 4779, Vol. 594 C. C. H. Standard Fed. Tax Reports.

[28] Sec. 1.1301-2, Regulations, Reynolds v. Commr. 249 F. 2d 259 (4th Cir. 1957) (Salesman); Hoffman, et al. 11 T. C. 1057 (1948) (management compensation); F. S. Ranz, 31 T. C. 91 (1958). See: Sec. 1.1301-2, Regulations, Par. 4779A, Vol. 594 C. C. H. Standard Fed. Tax Serv.

[29] Sec. 1307, I. R. C. 1954 sets out rules for tax computation.

ployment to perform creative intellectual work at the general direction of the employer probably would not be covered even if it was confined to a special field such as development of new drug chemicals, electronic devices, pumps, etc. or to programs presented over the air by a particular performer.

Invention or Artistic Work

Long term income from an invention or artistic, literary and musical work covering a period of twenty-four months from beginning to completion is eligible for tax limitation under Sec. 1302. The qualifying requirement here is twenty-four months, whereas it is thirty-six months for compensation from an employment under Sec. 1301. However, the requirement relating to percentage of gross income received in a particular year is the same in both sections; that is, a taxpayer qualifies by receiving in one year eighty percent of the entire amount.

Unlike the employment compensation rules in Sec. 1301, which allow a lump sum received to be spread back over the actual time in which it was earned, Sec. 1302 limits the "spreadback period" to sixty months for inventions and thirty-six months for an artistic work. Consequently, a taxpayer receiving a lump sum equal to eighty percent of his total compensation for a play, musical comedy or an artistic work which took him six years to complete can only spread back his income over a thirty-six month period.[30] Even in allowing "spreadback" tax limitations, Congress has granted inventions more favorable treatment than copyrights and similar property.

Certain other technical features of this portion of the Code must be observed carefully. For instance, in the case of compensation from long term employment, special tax benefits are available if the amount received in any one year equals eighty percent of the total compensation.[31] But Sec. 1302 requires that sums received in one year from an invention or artistic work must be added to those received in prior years, plus any amount received in the twelve months immediately following the close of the taxable year.[32] Also, the term "invention" is limited to a "patent covering an invention by an individual." Therefore, income from scientific processes, chemical formulae and mechanical devices which have not yet been patented or cannot be patented

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30 Sec. 1302, (a) (3), I. R. C. 1954.

31 Sec. 1.1302-1, Regulations, Par. 4785, Vol. 594 C. C. H. Standard Fed. Tax Serv.

32 Difficulties encountered in applying Sec. 1302 because of time when income was actually received may be resolved by invoking doctrine of constructive receipt. James Gould Cozzens, 19 T. C. 663 (1953) (Royalties not constructively received in prior year because they were not then subject to author's unqualified right of demand and use). Compare: McEuen v. Commissioner, 196 F. 2d 127 (8th Cir. 1952), 521 U. S. T. C. Par. 9281, where it was found that payment was constructively received in the year when it was freely available.

are excluded from any special tax spreading benefits. Income from sale of pending applications also does not qualify. Finally, income treated as capital gains to inventors, artists, writers and musicians does not qualify.

When Work Begins

An author, composer or inventor sometimes carries ideas around in his mind for a long time before he puts down a single word on paper, writes a note of music or draws a sketch of his invention. Even after he makes a start, months or years of research and experiments may elapse before actual completion of the work.

Does the time spent in thinking or in research count as part of the period of twenty-four months from beginning to completion of the work which Sec. 1302 fixes as a prerequisite to qualification for tax-spreading benefits? There is no statutory definition of the amount of work required or the nature, kind or extent of activity which must be proven to show commencement of the twenty-four month work period.

In the case of *I. D. Richardson,*[33] the Tax Court ruled that work began on a book of war memoirs on the date when the author first made written notes of his experiences. The evidence showed a persistent intention on the part of Richardson to write this book; therefore, the Court rejected the government's contention that time spent in collecting and preparing material which was not included in the final version of the book should be omitted in computing the statutory work period. Richardson testified that he had prepared two previous versions of the book and had accumulated voluminous notes which had been lost on two different occasions through enemy action and shipwreck. On these facts, it was held that time spent in preparing lost and discarded written material should be included as part of the total time spent on the entire endeavor.

Sec. 1302 was intended as a relief statute, but later decisions have adhered to the rule in the *Richardson* case. Although the Tax Court again held that the work period begins with the date of the first written memorandum, its decision in the *Blum* case[34] indicates that no particular amount of continuous activity in writing a manuscript or typing notes is required to maintain a creative work status throughout the entire twenty-four month period.

Nearly five years elapsed from the time when Blum first conceived the idea until he sold a motion picture play about a goddess who became a living person and fell in love with a Broadway character whom she could not marry because he was a mortal. During this period, Blum did little writing or typing on his story.

[33] Iliff David Richardson 14 T. C. 547 (1950).

[34] Edwin H. Blum 11 T. C. M. 612, Tax Court Memo. Op., Docket No. 25711 (1952).

The bulk of his work consisted of research for background material and discussing his idea about a supernatural story with other writers. After selling the story to Columbia Pictures Corporation for $25,000.00, he claimed the right to distribute this income on a long-term basis extending back from the date of sale. A year after the sale, he made an affidavit in defense of a proposed plagarism suit that a written note of an idea he had picked up while reading a magazine was made about five years before selling his story and that it was recorded in a notebook which he had kept specifically for such purpose. Stirred by this idea, he did considerable research on Greek mythology, all of which he claimed influenced him in working out the final story. The Tax Court agreed that the required number of calendar months was covered by the taxpayer's work. In its opinion, the Court commented that:

> "In applying the intent of the statute to work entailed in writing a dramatic composition, it would be sophistic if we were to separate the work into (a) physical labor, such as typing, and (b) mental labor, and to hold that (a) should be counted as work on the project but that (b) should not. The construction of a plot, the development of the characters and the crystallization of the story theme into terms of conflict, suspense and final resolution are the results of mental activity. In terms of essentiality, the mental activity is more important than the physical work of writing or typing."

While finding in favor of the taxpayer on the question of qualification for long term benefits, the Tax Court disagreed with his contention that the required number of months should be dated backward from the date on which the story was sold. Following the decision of the Supreme Court in *Robertson v. United States*,[35] the Court required Blum to allocate the gain received from sale of his story over a period of months preceding the close of the taxable year, even though the sale occurred in September. It is significant that the months in the taxable year subsequent to receipt of the income cannot be excluded in a computation under Sec. 1302.

Another illustration of the strict construction of the term "work" is to be found in *Beardsley v. United States*,[36] a case arising under the prior law when a thirty-six months qualifying period was imposed. There, the first reduction to writing or drawing, pertaining to an invention of an air flow fuel economizer for aircraft engines, occurred thirty-five and one-half months before the date of filing a patent application. But, the taxpayer testified that the idea for his invention came to him at least six months before that date and that he thought it over continuously until he made his first written notation.

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[35] 52-1 U. S. T. C. 9343, affg. 190 F. 2d 680 (U. S. 1952).

[36] 56—U. S. T. C. 9374 (1956)

Beardsley claimed the benefit of long-term income tax relief, but his action for refund was decided in favor of the Government. The District Court stated that petitioner did nothing more than carry the idea in the back of his mind from November of one year until April of the following year when he made his first drawing. Even though he kept looking at data in this field in the course of his regular work as an engineer, there had been no commencement of "work" in the statutory sense. Furthermore, eleven years before the trial of the tax refund suit, Beardsley had testified in a patent infringement suit that he began actively exercising reasonable diligence in adapting and perfecting his invention during the April period.

The *Beardsley* decision is important because it defines "work," as used in this statute, to mean:

> "something more than the germinating of the idea and mental notice taking of passing data prior to the demonstrable decision to take affirmative action to perfect the idea."

In 1957, the Tax Court held that even if it were assumed, contrary to the *Beardsley*[37] and *Richardson*[38] cases, that work on a meat curing invention began when the idea was first conceived, less than thirty-six months had elapsed to completion. The date on which a patent application was filed embodying the complete process or device was fixed as the completion date. The taxpayer claimed that the development work carried on during the next two years should be included.[39] But, the Court ruled that this effort was directed solely toward commercial development of the process, but no work was being done on the patent covering the invention. In this case, there was no change in the patent application after the first filing date. A different conclusion probably would be reached where the patent application itself was modified and revised while pending in the Patent Office, especially if the process or device described is improved by such additional work.

Tax Discrimination

It is clear from Sec. 1302, that inventors have at least twice as many tax relief opportunities as composers, authors and musicians. If they do not come under Sec. 1235, inventors still may acquire capital gains in the regular way. Even when capital gains are lost entirely, long-term income tax relief is available for inventors under Sec. 1302. Literary, musical and artistic talent cannot acquire similar capital gains, and only Sec. 1302 provides them with protection against unduly harsh tax burdens.

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37 Supra, note 36.

38 Supra, note 33.

39 Murray T. Morgan, 16 T. C. M. 262, Docket No. 59208 (1957). While the Richardson, Blum and Morgan cases involved Sec. 107(b) of the 1939 Code, the same basic principles are applicable to the interpretation of Sec. 1302 of the Revenue Code of 1954.

Authors, composers and artists have many of the same financial and creative problems as inventors. Yet, Congress has perpetuated an inequality in their treatment under the income tax laws. It seems absurd that a scientist can report the proceeds from the sale of a new invention, patentable process, formula, etc. as long-term capital gains, but that he would be subject to ordinary income tax rates if he sold the rights to a book describing this very same work.

Conclusion

There should be a uniform allowance of long-term capital gains, or else the tax relief for patents, copyrights and copyrightable works should be restricted entirely to "spread-backs" similar to those now permitted by Sec. 1302. The actual time elapsed from commencement to completion of the work should be used as the limits of the recomputation period, rather than some arbitrary period such as thirty-six or sixty months. Consistency in this field also calls for elimination of existing distinctions between the treatment of compensatory damages for patent infringement and those for infringement of copyrights, trademarks and trade-names.

NOTE: Tax problems arising from litigation, settlements and application of long-term tax limitation statutes are discussed in more detail by the author in his article on "Taxation of Damages," Fall Issue, 1959, Univ. of Pittsburgh L. R. See also, Kennett, Tax Aspects of Jury Valuation of Future Earnings, 6 Clev-Mar. L. R. 282 (1957).